

Internal Revenue Service
memorandum

TL-N-7848-89

CC:TL:TS/JLRICKS

date: AUG 18 1989

to: District Counsel, Seattle W:SEA

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]
Request for Tax Litigation Advice

This memorandum is in response to your request for tax litigation advice, dated June 19, 1989.

Issue

Whether payments made by the taxpayer, after a petition has been filed in Tax Court and prior to the entry of a decision, must be subtracted from the "understatement" to arrive at the "amount of any underpayment" in computing the addition to tax under section 6661(a)?

Facts

On [REDACTED], the Service issued a statutory notice of deficiency to petitioners for tax years [REDACTED] and [REDACTED]. The deficiency notice also asserted additions to tax for those years, including section 6661. Petitioners then filed a petition with the Tax Court. On [REDACTED], petitioners paid \$[REDACTED] pursuant to IRS Announcement 86-108. Petitioners' payment was applied as follows:

1. \$[REDACTED] to the tax deficiency;
2. \$[REDACTED] to interest; and
3. To the extent that such payment is greater than the interest due on the tax payment, the excess is to be applied on a pro rata basis between the tax deficiency and interest on the deficiencies.

Petitioners contend that their own understatement of tax:

1. \$[REDACTED] for [REDACTED]; and
2. \$[REDACTED] for [REDACTED],

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should be reduced by their post petition payment to arrive at the amount of the "underpayment" in computing the section 6661 addition to tax.

Discussion

Section 6661(a) provides that "[i]f there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement." The statute further defines the word understatement as the excess of "(i) the amount of the tax required to be shown on the return for the taxable year, over (ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2))." I.R.C. § 6661(b)(2). However, the term "underpayment" is not defined in the statute.

The Tax Court, in a reviewed opinion, recently defined the word "underpayment" for purposes of section 6661 in Woods v. Commissioner, 91 T.C. 88 (1988). The petitioner in Woods failed to file a federal income tax return in 1983, although he received \$32,844 in wages and \$53 in interest income during the year. Respondent determined a deficiency in petitioner's tax of \$7,152, as well as additions to tax, including section 6661(a). Petitioner argued that respondent had not given him credit for withholding taxes of \$3,813.77 in calculating the addition to tax under section 6661.

Respondent argued that the word "underpayment" should be construed as synonymous with the word "understatement", as Treas. Reg. § 1.6661-2(a) attempted to do.^{1/} In calculating the "understatement", Treas. Reg. § 1.6661-2(d)(5)(i) provides that withheld taxes are not included in determining both (1) the amount of tax shown on the return for the taxable year and (2) the amount of tax required to be shown on the return for the taxable year. The Tax Court rejected respondent's argument.

Rather, the Court found that, looking at the ordinary meaning of the word, the term "underpayment" means "the amount by which the payment was insufficient." 91 T.C. at 99. The Court noted that this interpretation of underpayment is analogous to

^{1/} Treas. Reg. § 1.6661-2(a) states that:

If there is a substantial understatement of income tax for a taxable year (as defined in paragraph (b) of this section), section 6661 imposes a penalty equal to [25] percent of the understatement of tax liability.

(Emphasis added).

the meaning given this term in sections 6654(b), 6655(b) and 6656(a). 91 T.C. at 97, n.17. The Court reasoned that petitioner's "underpayment" was not caused by his failure to report his income on a tax return, but rather by his failure to pay all of the tax that he owed. Thus, the Court found that the 25% rate should be applied to the understatement reduced by the amount of the withheld taxes, rather than to the entire understatement. Id.

Moreover, the Tax Court found that Congress did not intend this result when enacting section 6661. Id. at 97, n.18. Wage earners frequently overpay their tax by their withholding, yet fail to file income tax returns to recover refunds which they are owed. In this situation, respondent's interpretation would result in the imposition of the section 6661 penalty equal to 25% of their entire tax even though it had been fully paid.

The [REDACTED] argue that, following the Woods case, their understatement of tax for [REDACTED] and [REDACTED] should be reduced by their post petition payment in order to calculate their "underpayment" for purposes of section 6661(a). However, post petition payments are significantly different from withheld taxes ("prepayment credits") so that the holding in Woods would not apply. In Woods, the Tax Court only considered timely deposited wage withholding payments to reduce the understatement. The Tax Litigation Division has taken the position that timely made wage withholding and estimated tax payments, carryover payments (overpayments from a prior year) elected to be applied to the current year prior to the due date for payment, and amounts that were seized and paid as tax on termination assessments prior to the due date for payment would also reduce the understatement for purposes of arriving at the "underpayment." See LGM, "Underpayment" for purposes of the Substantial Understatement Penalty when no return is Filed, Woods v. Commissioner, 91 T.C. No. 11 (1988), TL-55 (August 10, 1988) at 4. For these purposes, the "due date for payment" is the due date of the tax return for the year in question without regard to extensions. I.R.C. § 6151.


On the other hand, the [REDACTED] post petition payment was not a timely payment for the tax years in issue. The Tax Litigation Division has taken the position that payments made after the due date for payment and payment credits applied to the liability after the due date for payment are not the type of "prepayment credits" contemplated by the Court in Woods. LGM TL-55, supra, at 4. Thus, they would not reduce the understatement for purposes of calculating the underpayment. Accordingly, the [REDACTED] post petition payment, made on [REDACTED], would not reduce their understatements in [REDACTED] and [REDACTED] for purposes of determining the amount of the underpayment. The [REDACTED] post petition payment would, however, reduce the

amount of the unpaid tax for purposes of calculating interest under section 6601.

If this issue cannot be settled and proceeds to trial, please make sure that the brief is sent in for prereview.

If you have further questions concerning this tax litigation advice, please contact Jo Lynn Ricks at FTS 566-3350. This tax litigation advice was coordinated with Branch No. 3, Tax Litigation Division, which agrees with the analysis and result stated herein.

MARLENE GROSS

By: 
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